



DOCUMENT OF
THE WORLD BANK

West Bank and Gaza

Financial Sector Review

December 2008

Finance and Private Sector Group
Social and Economic Development Department
Middle East and North Africa Region

/...

TABLE OF CONTENTS

EXECUTIVE SUMMARY - i

I. THE BANKING SECTOR - 1

- A. Providers and products - 1
- B. Access to banking services - 4
- C. Regulation and supervision - 7
- D. Market development - 9

II. THE SECURITIES MARKET - 13

- A. Providers and Products - 13
- B. Regulation and supervision - 15
- C. Market development - 18

III. INSURANCE - 20

- A. Providers and products - 20
- B. Regulation and supervision - 21
- C. Market development - 23

IV. PENSION FUNDS - 23

- A. Providers and products - 23
- B. Regulation - 24
- C. Market development - 24

V. FINANCIAL LEASING - 24

- A. Providers and products - 24
- B. Regulation - 25
- C. Market development - 26

VI. MICROFINANCE - 27

- A. Providers and products - 27
- B. Regulation - 29
- C. Market development - 29

VII. HOUSING FINANCE - 30

- A. Providers and products - 30
- B. Regulation - 32
- C. Market development - 32

VIII. PAYMENTS SYSTEM - 34

IX. SUMMARY OF RECOMMENDATIONS - 35

- A. Banking Sector - 36
- B. The Securities Market - 37
- C. Insurance Sector - 37
- D. Pension Funds - 38
- E. Financial Leasing - 38
- F. Microfinance - 38
- G. Housing Finance - 39
- H. Legal Environment - 40

APPENDICES

- Appendix 1 - 41
- Appendix 2 - 42
- Appendix 3 - 43
- Appendix 4 - 44
- Appendix 5 - 45
- Appendix 6 - 46

BOXES

- Box 1: Banks' Recovery from Political Turmoil - 1
- Box 2: Currency in Gaza - 3
- Box 3: Loan Guarantee Programs in WBG - 12
- Box 4: Legal Environment: Company Law and Creditors' Rights - 19
- Box 5: Legal Environment: Enforcement of Contract Rights - 26

FIGURES

- Figure 1: Non Performing Loans (% total loans) - 2
- Figure 2: Deposit accounts per 1,000 persons & GDP / capita - 4
- Figure 3: Credit to private sector - 5
- Figure 4: Use of bank finance - 6
- Figure 5: Number of branches per 100,000 persons - 11

TABLES

- Table 1: Assets & Profits of Banks in WBG (2004-07) - 1
- Table 2: Aggregate Loan Portfolio Quality of Banks in WBG (2004-07) - 2
- Table 3: Breakdown of Gross Credit of Banks in WBG to Public and Private sectors (2004-07) - 5
- Table 4: PSE Trading (2003 to 2007) - 14
- Table 5: Securities Firms' Assets and Capital - 15
- Table 6: Investors in PSE Listed Securities - 15
- Table 7: Insurance Companies Aggregate Statistics - 20
- Table 8: Premia on Classes of Insurance Underwritten - 21
- Table 9: Summary of Microfinance Institutions in West Bank and Gaza - 28

EXECUTIVE SUMMARY

- i. The formal financial sector in WBG emerged some 15 years ago, after 1993-1994 with the signing of the Oslo Accord in 1993 and the Paris Protocol in 1994. The latter provided Palestinians the authority to administer monetary and financial affairs in order to support the expected economic growth.
- ii. Those expectations were never fully realized because of on-going restrictions on mobility of persons and goods and on access to natural and financial resources imposed by Israel. In the last several years the Palestinian economy has been in steady decline. Per capita GDP is estimated to have fallen by nearly 30.0 percent from its height of USD 1610 in 1999 to around USD 1,130 in 2006. Except for a short period between 2003 and 2005, when the economy was recovering, growth was negative every year since 2000. During the last two years the decline has accelerated. GDP contracted by nearly 8.8 percent in 2006 and by 4.2 percent in the first quarter of 2007. In 2007 the growth rate was near zero and in it is projected to be only one percent in 2008.
- iii. In spite of the difficult environment, the Palestinians have managed to establish a financial sector composed of most of the expected sub-sectors: banks, a securities market, insurance companies, payments system, housing finance companies, microfinance institutions and financial leasing companies. Yet, important needs for financial services have not been met (for micro-credit, households, and SMEs).
- iv. The Palestinian Authority (PA) has established two main institutions to regulate and supervise the financial sector: the Palestinian Monetary Authority for the banking sector (as well as payments system, micro finance institutions and money changers), and the Capital Market Authority for the non-banking sector (securities market, financial leasing, mortgage finance companies, pension funds, and insurance companies). The development of those subsectors, as well as the regulatory bodies, is uneven and the PA's monetary powers and sovereignty remains limited since it has no national currency, which therefore narrows the scope for influencing monetary and economic conditions.
- v. Assuming that the potential of the West Bank and Gaza economy is unleashed, which would require a major dismantling of today's closure regime, the financial sector, as it appears now, would be ready to play an active role. That said, the PA should continue to refine and strengthen this sector to improve its functioning under the current constraints. Those efforts would also fully benefit the West Bank and Gaza economy if and when the political situation eases. In the meanwhile, the PMA should pursue its goal of becoming a full-fledged central bank, while the CMA would benefit from capacity building support so they can play a more effective role as regulator of the various sub-sectors for which it is responsible.

Banking Sector

- vi. As in most developing countries, the banking sector dominates the financial sector. Banks are generally in sound financial condition and products are well developed as is the regulatory infrastructure. However, the sector remains vulnerable due to its dependence on the Jordanian banking system and, from an operational point of view, on the Israeli one. Due to a large extent to the current political instability and to the depressed economic activity, banks play a very limited role in the financing of the WBG economy. The cautiousness of the banks reflects various structural problems such as the lack of suitable collateral and the uncertainty of the outcome in debt collection. Important steps have been taken by the PMA to develop the banking system and improve its stability (credit bureau, payments system, capital requirements and regulations on secured credit). Additionally, two bank loan guarantee programs to largely substitute for the lack of acceptable collateral for small and medium enterprises (SMEs) were successfully launched. Despite the current economic situation, those programs should

continue to expand.

vii. While the current efforts of the PMA to develop the sector should continue including enactment of a new banking law to provide better basis for implementation of all of the Basel Core Principles, extending the network of the credit bureau, and completing the installation of the payments system, the PA should also consider strengthening the financial infrastructure by promoting out-of-court settlement for debt collection and establishing a national registry for pledges of movable property to increase the array of collateral likely to be accepted by banks to secure credit facilities.

Payments System

viii. The payments system has a number of weaknesses and vulnerabilities which are magnified by the multi-currency status of WBG as well as the movement and access restrictions resulting from the closure regime. While some banks have electronic payment instruments for their customers, WBG remains mainly a paper-based financial transaction economy with cash being the dominant payment medium for the general public. Aware of the weaknesses and the importance of an effective and comprehensive payments system for the development of the WBG economy, the PMA, with the assistance of the World Bank, has embarked on a modernization program. Systemic risk will also be reduced by the planned introduction of liquidity management functions.

ix. With regard to non-banking sector, insurance and microfinance are fairly well developed while financial leasing and housing finance have emerged only recently, private pension funds have yet to be established and the regulation and supervision of this sector began only 2 ½ years ago.

Securities Market

x. The capital market, which consists of underwriting of share issues and trading of shares on the Palestinian Stock Exchange (PSE), began 10 years ago. The activity is regulated by the CMA and the PSE, according to an allocation of responsibilities which should be clarified. Given the predominance of SMEs and family-owned enterprises in the WBG economy, there are only 35 listed companies thus far and the potential for new applicants appears limited. The PSE is thinly traded and the index is relatively high and very volatile, which could potentially amplify economic shocks. This situation reflects the fact that rumors rather than economic fundamentals move prices and also that numerous individual investors with limited financial knowledge buy shares directly on the stock exchange.

xi. Given the current situation, the CMA may want to consider various measures to develop the market such as the establishment of professionally managed investment funds for investment in securities, the definition of its respective regulatory and supervisory roles vis-à-vis the PSE and the development of a bond market. Also, the PA may wish to consider amending the Law of the CMA to give it more political independence.

Insurance

xii. With 2.5 percent of the financial sector's assets, insurance companies do not play the role as those in other countries as important institutional investors. The contribution of insurance premia to GDP was only 1.6 percent in 2006 while the spending on insurance per capita was about USD 18 compared to the average of 2.7 percent and USD 60 in developing countries. This situation mainly reflects depressed economic activity, transit restrictions and limited public awareness of insurance products.

xiii. The insurance industry was not supervised for ten years until 2005 and remedial supervisory measures are underway by the CMA. Insurance products are varied but overall income has declined due to the marked reduction in underwriting of compulsory motor vehicle insurance. The legal and regulatory infrastructure for insurance is based on international practices and the Council of Ministers and CMA have issued prudential and market conduct regulations. Market development depends mostly on an increase in economic activity though some new products were recently introduced that are promising. The CMA should endeavor to strengthen companies' operations to enable them to qualify for high international ratings and for reinsurance of a major portion of their liabilities by highly rated reinsurance companies.

Financial Leasing

xiv. Financial leasing is in its infancy. There are four active companies leasing mainly motor vehicles for commercial fleets. Some basic regulations have been issued by the CMA and a leasing law is under development. That law may stimulate more interest in the activity. The CMA should issue market conduct regulations and the companies should develop a consumer education campaign to promote financial leasing of commercial and industrial equipment in addition to automobiles.

Housing Finance

xv. Housing needs are great in WBG, but price levels and spatial restrictions, partly due to the on-going Israeli settlement activity in the West Bank and the existence of restricted roads and areas, constrain the effective demand while products available for finance housing demand are too limited. The Palestinian Mortgage and Housing Corporation (PMHC) that provides refinance and mortgage guarantees had a catalytic effect in the emergence of mortgage lending but has lost its attractiveness for primary lenders. The Palestinian Investment Fund (PIF) is working on late stage plans to help address housing and mortgage finance needs by developing a large-scale, affordable housing project and is in advanced negotiations to establish a mortgage finance company.

xvi. To further develop the market, the PA should improve the legal and regulatory environment (strengthening and modernization of the mortgage lending framework, development of a framework for the financing of housing development, and alignment of CMA and PMA regulations in respect of mortgage lending and housing finance) and take steps to foster market development and facilitate access to housing by moderate income groups in conjunction with the PIF initiative. This should include, inter alia, the reform of the PMHC to improve its services to the market and the building of lender's capacities. The adoption by the CMA of appropriate prudential and market conduct regulations will also be key element for the emergence of a sound housing finance sector.

Microfinance

xvii. Microfinance is well developed in its offering of products that are essentially only credit but apparent needs far exceed the funding capacity at present. Funding is by donors and reinvested profits. MFIs are not currently sustainable.

xviii. Operations infrastructure of the nine nonbank providers is being strengthened and a regulatory framework is being developed by PMA that should require MFIs to be organized as companies with effective corporate governance structures and procedures and contain rules for market conduct. If MFIs were permitted to take deposits from the public or convert to banks with moderate regulatory requirements, as acknowledged by the Basel Committee on Banking Supervision, it would enable MFIs to become sustainable. Moreover, profitable and expanding MFIs should result in those institutions providing access to finance for the middle market (households and SMEs), thereby creating a financing continuum in the customer spectrum.

Pension Funds

xix. There are no privately managed pension products in WBG and the domestic financial sector currently lacks entities other than insurance companies which could offer or manage pension products. There are too few regulations in place for the provision of either pension products or the underlying products and

services. The CMA would need technical assistance to train its personnel, develop the necessary regulatory framework, and establish bilateral supervisory agreements with regulators in other countries.

Legal Framework

xx. The general legal framework supporting the financial sector should be considerably modernized and its enforcement made more efficient. The company laws applicable in WBG do not reflect the revolution in corporate governance in recent years. A corporate governance code is being developed but is reported to be only voluntary. For creditors' rights there should be modern rules for creation, registration and enforcement of pledges of moveable property. Some debt collection procedures are efficient but regular court proceedings are protracted and outcomes would benefit from modern case management and training of judges in commercial and financial matters.

Recommendations for Reforms

xi. The recommendations for reforms in this report are summarized in Section IX. Those and the actions undertaken and planned by the PMA and the CMA would provide an adequate financial sector structure and infrastructure to support expanded economic activity. In that respect, these actions would support the Palestinian Reconstruction and Development Plan which recognizes the importance of private sector development to meet its goals.

xii. Additionally, a comprehensive Financial Sector Development Plan could be considered, including monetary policy management issues (limitation of number of currencies, establishment of a money market, issuance of PA bonds). In any event, since there is no entity in WBG with responsibility for reform of the overall financial sector, the establishment of a steering committee composed of the main financial sector stakeholders, would seem to be appropriate to coordinate technical cooperation and to keep reform efforts on track.

/...

Full report:

[Complete document in PDF format](#) (Requires [Acrobat Reader](#))